

103 KAR 16:060. Income classification; business and nonbusiness.

RELATES TO: KRS 141.010(3), 141.120

STATUTORY AUTHORITY: KRS 131.130(1)

NECESSITY, FUNCTION, AND CONFORMITY: KRS 131.130(1) authorizes the department to promulgate administrative regulations necessary to administer and enforce Kentucky's tax laws. KRS 141.120 contains provisions for assigning to Kentucky the business income and nonbusiness income of multistate corporations. This administrative regulation establishes criteria for classification of corporate income into its business and nonbusiness components, allocates expenses for nonbusiness income, and clarifies that Kentucky follows both the transactional and functional tests.

Section 1. Definitions. (1) "Acquisition" means the act of obtaining an interest in property.

(2) "Allocation" means nonbusiness income specifically assigned or allocated to one (1) or more specific jurisdictions.

(3) "Apportionment" means business income divided among jurisdictions by use of the three (3) factor formula in KRS 141.120(8).

(4) "Business income" is defined in KRS 141.120(1)(a).

(5) "Disposition" means the act or the power to relinquish or transfer an interest in or control over property to another, in whole or in part.

(6) "Integral part" means property that constitutes a part of the composite whole of the trade or business, each part of which gives value to every other part, in a manner which materially contributes to the production of business income.

(7) "Management" means the oversight, direction, or control, directly or by delegation, of the property for the use or benefit of the trade or business.

(8) "Nonbusiness income" is defined in KRS 141.120(1)(e).

Section 2. Determination of Business Income. In determining whether income is business income, the Department of Revenue shall apply both the transactional test and the functional test as established in Sections 3 and 4 of this administrative regulation.

Section 3. Transactional Test. Under the transactional test, income shall be considered business income if the income arises from transactions and activities in the regular course of the taxpayer's trade or business in accordance with this section.

(1) If the transaction or activity shall be in the regular course of the taxpayer's trade or business, part of which trade or business is conducted within Kentucky, the resulting income of the transaction or activity is business income for Kentucky. Income may be business income even though the actual transaction or activity that gives rise to the income does not occur in Kentucky.

(2) For a transaction or activity to be in the regular course of the taxpayer's trade or business, the transaction or activity shall not be required to be one that frequently occurs in the trade or business.

(a) Most frequently-occurring transactions or activities shall be in the regular course of that trade or business and shall; therefore, satisfy the transactional test.

(b) It shall be sufficient to classify a transaction or activity as being in the regular course of a trade or business, if it is reasonable to conclude transactions of that type are:

1. Customary in the kind of trade or business being conducted; or
2. Within the scope of what that kind of trade or business does.

(c) If a taxpayer frequently or customarily engages in investment activities, if those activities are not for the operations of the trade or business, those activities shall not satisfy the transactional

test.

(d) The transactional test shall include:

1. Income from sales of inventory, property held for sale to customers, and services which are commonly sold by the trade or business; and

2. Income from the sale of property used in the production of business income of a kind that is sold and replaced with some regularity, even if replaced less frequently than once a year.

(3) The corporation shall classify income as business or nonbusiness income on a consistent basis. If the corporation is not consistent, it shall disclose in its Kentucky return the nature and extent of the inconsistency.

Section 4. Functional Test. Business income shall include income from tangible and intangible property, including any interest in, control over, or use in the property held directly, beneficially, by contract, or otherwise, that materially contributes to the production of business income, if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

(1) Under the functional test, business income shall not be required to be derived from transactions or activities that are in the regular course of the taxpayer's own particular trade or business.

(a) Except as provided in paragraph (b) of this subsection, it shall be sufficient if the property from which the income is derived is, or was an integral, functional, or operative component used in the taxpayer's trade or business operations, or otherwise materially contributed to the production of business income of the trade or business, part of which trade or business is or was conducted within this state.

(b) Property that has been converted to nonbusiness use through the passage of a sufficiently-lengthy period of time (generally, five (5) years shall be sufficient) or that has been removed as an operational asset and is instead held by the taxpayer's trade or business exclusively for investment purposes, shall be deemed to have lost its character as a business asset.

(c) Property that was an integral part of the trade or business shall not be considered converted to investment purposes merely because it is placed for sale.

(2)(a) Income that is derived from isolated sales, leases, assignments, licenses, and other infrequently-occurring dispositions, transfers, or transactions involving property, including transactions made in liquidation or the winding-up of business, shall be business income, if the property is or was used in the taxpayer's trade or business operations, unless the property has been converted to nonbusiness use.

(b) Income from the licensing of an intangible asset, such as a patent, copyright, trademark, service mark, know-how, trade secrets, or the like, that was developed or acquired for use by the taxpayer in its trade or business operations, shall constitute business income whether or not the licensing itself constituted the operation of a trade or business and whether or not the taxpayer remains in the same trade or business from or for which the intangible asset was developed or acquired.

(3) Under the functional test, income from intangible property shall be business income if the intangible property shall serve an operational function as opposed to solely an investment function. The intangible property serves an operational function if it is or was held in furtherance of the taxpayer's trade or business as evidenced by the objective characteristics of the intangible property's use or acquisition and its relation to the taxpayer and the taxpayer's activities. The functional test shall not be satisfied if the holding of the property is limited to solely an investment function for a period of five (5) years or more.

(4) If the property is or was held for furtherance of the taxpayer's trade or business, income from that property may be business income, even though the actual transaction or activity involving that property that gives rise to the income does not occur in Kentucky.

(5)(a) An item of property shall be presumed integral to the taxpayer's trade or business operations if the taxpayer:

1. Takes a deduction from business income that is apportioned to Kentucky; or
2. Includes the original cost in the property factor.

(b) A presumption shall not arise from the absence of an action described in paragraph (a) of this subsection.

(6) Application of the functional test shall be unaffected by the form of the property (e.g., tangible or intangible property, real or personal property).

(a) Income arising from an intangible interest as, for example, corporate stock or other intangible interest in a business or a group of assets, shall be business income if the intangible itself or the property underlying or associated with the intangible is or was an integral, functional, or operative component to the taxpayer's trade or business operations.

(b) While apportionment of income derived from transactions involving intangible property as business income may be supported by a finding that the issuer of the intangible property and the taxpayer are engaged in the same trade or business, establishment of a similar relationship shall not be the exclusive basis for concluding that the income is subject to apportionment. It shall be sufficient to support the finding of apportioned income if the holding of the intangible interest served as an operational asset.

Section 5. Relationship of Transactional and Functional Tests to the U.S. Constitution. The Due Process Clause and the Commerce Clause of the U.S. Constitution restrict states from apportioning income that has no rational relationship with the taxing state. Satisfaction of either the transactional test or the functional test shall comply with this constitutional requirement, because each test shall require that the transaction or activity (in the case of the transactional test) or the property (in the case of the functional test) be tied to the same trade or business that is being conducted within this state.

Section 6. For taxable years beginning after December 31, 2004, corporations defined in KRS 141.010(24)(a) to (h), limited liability entities, limited partnerships, and S corporations, shall include as part of their calculation of taxable income, separately stated items of distributive share income. The separately-stated items of distributive share income shall be deemed business income if the items meet the transactional test, functional test, or a holding period of less than five (5) years in the case of an investment.

Section 7. Expenses Related to Nonbusiness or Nontaxable Income. (1) KRS 141.010(13)(d) requires that any deduction allowed under Chapter 1 of the Internal Revenue Code shall be reduced by expenses directly or indirectly related to nontaxable or nonbusiness income. If actual expenses, including interest, salaries, general and administrative, and other stewardship expenses, is not related directly to the income, one (1) of the following formulas shall be used:

(a) Ratio of nonbusiness/nontaxable assets to total assets times interest expense. Interest expense shall represent all expenses incurred in the stewardship or maintenance of nonbusiness or nontaxable assets. Other expenses may be used which more fairly reflect expenses attributable to the income or assets producing the nonbusiness/nontaxable income. Assets shall be valued at cost, and the investment account shall exclude equity;

(b) If the total nonbusiness/nontaxable income does not exceed fifty (50) percent of the total gross receipts, the expenses not deductible under paragraph (a) of this subsection may be reduced proportionately but not to exceed fifty (50) percent of the calculated expenses;

(c) 1.75 percent of the cost of assets producing nonbusiness/nontaxable income;

(d) Ratio of nonbusiness/nontaxable income to total gross receipts times interest expense, of-

ficers' salaries, and general administrative expenses. The sum of these or any reasonable combination of these expenses; or

(e) A flat percentage, one (1) percent to 100 percent, of nonbusiness/nontaxable income. The percentage used shall be reasonable and reflect the expenses attributable to the stewardship or maintenance of the assets producing the income.

(2) KRS 141.010(13)(d) requires a corporation to relate expenses to nonbusiness and nontaxable income. The formulas listed in subsection (1)(a) to (e) of this section for determining related expenses shall be used by the corporation or assist the corporation in developing a method more suitable to its particular situation.

Section 8. Proration of Deductions. Any allowable deduction that applies to both business and nonbusiness income or to more than one (1) trade or business shall be prorated to those classes of income or trades or businesses by the formulas listed in Section 7 of this administrative regulation.

Section 9. Revenue Policy 41P150 "Expenses Related to Nonbusiness Nontaxable Income", shall be withdrawn, since the policy has been incorporated into this administrative regulation.

Section 10. The amendments to this administrative regulation shall apply to tax periods beginning on or after January 1, 2005. (IC-6-1; 1 Ky.R. 138; eff. 12-11-74; Am. 3 Ky.R. 382; eff. 12-1-76; 32 Ky.R. 1716; 2284; 33 Ky.R. 59; eff. 8-7-2006.)